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CHARLES ELMORE

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1940

No. 958

KETTLEMAN HILLS ROYALTY SYNDICATE No. 1 (a trust),

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit
and
BRIEF IN SUPPORT THEREOF.

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ARGUMENT.

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PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit.

To the Honorable Charles Evans Hughes, Chief Justice of the United States, and to the Associte Justices of the Supreme Court of the United States:

Your petitioner, Kettleman Hills Royalty Syndicate No. 1, a trust, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit entered December 19, 1940, wherein that court in an

opinion (R. 138) reported in 116 Fed. (2d) 382, affirmed a decision of the United States Board of Tax Appeals. The memorandum opinion of the Board of Tax Appeals is unreported (R. 32).

JURISDICTION.

Judgment of the Circuit Court of Appeals was entered December 19, 1940 (R. 143). Petition for rehearing, filed January 17, 1941, was denied on January 21, 1941 (R. 144). The jurisdiction of this court is invoked under 28 U.S.C.A. Sec. 347 (Jud. Code Sec. 240, as amended).

QUESTIONS PRESENTED.

This petition presents the following questions:

1. Whether the making of successive annual tacit decisions by trustees of a common law trust of quasi-corporate form over a period of years and from the inception of said trust always to receive in cash royalties to which the trust was entitled by contract from oil and gas production by others, rather than in kind, is the doing of business rendering said trust liable to income and excess-profits taxes as an association for that reason under the provisions of Sec. 801(a)(2) of the Revenue Act of 1934 and/or Sec. 1001(a)(2) of the Revenue Act of 1936, where by virtue of its royalty contract the trustees could have elected not oftener than once a year to receive said royalty in kind, and where the provisions of the trust

indenture creating said trust were sufficiently broad to have permitted said trust to store, sell and otherwise treat and dispose of such oil and gas had such election to take in kind been exercised?

2. Whether the acts of petitioner in consenting as a royalty holder to its obligor's assignment of government "A" and "B" oil and gas leases to a corporation organized by the operators in the so-called North Dome of Kettleman Hills oil field in Kings County, California, for unified development, conservation and production of oil and gas in said field and similarly consenting as royalty holder to the assignment by its obligor as lessee of government oil and gas leases with respect to the so-called Middle Dome of said oil field, pursuant to requests for such consents made to petitioner by its obligor and representatives of the Department of the Interior in connection with a governmental oil and gas conservation program then being carried out in said area, accompanied by petitioner's execution of agreements with its obligor modifying its original royalty contracts to the extent of providing for the payment to it of the same percentages of royalty, but from obligor's pro rata of the general production from the area subject to the conservation arrangement, rather than from the specific acreage covered by the original royalty contracts (except that as to the North Dome area petitioner's royalty as to "B" acreage was increased from 2½% to 3½% while subject to such conservation plan), constituted the doing of business by petitioner rendering it liable to income and excess-profits taxes as an association for that reason under

the provisions of Sec. 801(a)(2) of the Revenue Act of 1934 and/or Sec. 1001(a)(2) of the Revenue Act of 1936, where the reason given by the court for such holding of doing business was that such acts required the exercise of petitioner's "business judgment"?

STATUTES INVOLVED.

The Revenue Act of 1934 (C. 277, 48 Stat. 680, Sec. 801(a)(2) (26 U.S.C.A. Sec. 3797(3)) provides that:

> "Sec. 801. Definitions.
> (a) When used in this Act—
> (2) The term 'corporation' includes associations, joint-stock companies, and insurance companies."

Subsections (a)(2) of Sec. 1001 of the Revenue Act of 1936 (C. 690, 49 Stat. 1648, Sec. 1001(a)(2)) are identical with those quoted above.

STATEMENT.

A summary statement of the facts, which were all stipulated, and found by the Board of Tax Appeals as stipulated (R. 33, 42-122), follows:

Under date of July 9, 1924, as modified by an agreement between the same parties dated February 9, 1930 (R. 86), one Smith entered into a contract with Associated Oil Company, a corporation, hereinafter called Associated, whereby said Smith as the owner by assignment of a certain United States oil

and gas prospecting permit covering certain lands in what is known as the "Middle Dome of Kettleman Hills oil field" in Kings County, California, authorized Associated to enter said property, make discovery of oil or gas, secure a government lease, and operate said property in the production of oil or gas, reserving a royalty of one-sixth of the net production therefrom (R. 42, 82).

Under date of May 5, 1928, the same parties entered into a contract (R. 91) whereby Associated agreed to pay said Smith the sum of $5000.00 on the production of oil or gas and overriding royalties of 7½ per cent and 2½ per cent of the value at the well of oil and gas produced and sold by Associated under government "A" and "B" oil and gas leases respectively, when secured by Associated on lands in what is known as the "North Dome of Kettleman Hills oil field" in Kings County, California, covered by an oil and gas prospecting permit in the name of one Watson (R. 42, 43). Said contract provided that at Smith's option, exercised not oftener than once in any one calendar year, Associated would deliver said royalty in kind (R. 92).

Smith assigned his interest in said contracts to one Jacoby (R. 43).

Subsequent thereto, on May 3, 1930, an agreement and declaration of trust was entered into in writing by and between said Jacoby and the three trustees of petitioner, wherein and whereby, said Jacoby, as Smith's successor in interest, assigned said contracts to said trustees in consideration of their issu-

ance to him of 4000 transferable units of beneficial interest in said trust, representing the entire beneficial interest in the trust estate thus created (R. 43-45), each unit entitling the holder thereof to receive a one-four-thousandth pro rata of the royalties and other income received by the trustees, after the deduction of costs and expenses of administration of the trust (R. 45). Jacoby sold these units to the public for his own account, so that the units were acquired and are now held by various holders (R. 45-46).

Said trust agreement provides *inter alia* (R. 59-95): that the trust is to continue for twenty-five years (subject to prior termination by the trustees if oil and gas should cease to be found and produced in paying quantities upon the properties covered by said contracts (R. 79)) through three self-perpetuating trustees (R. 70), the beneficiaries having no vote or voice in its management; its affairs to be conducted through meetings of its trustees by resolutions adopted by them, its resolutions being kept in a minute book for that purpose; the trustees to hold in trust the legal title to all property at any time belonging to the trust with the exclusive management and control of the same (R. 68); the trustees to collect and distribute the net income and profits therefrom to the holders of its certificates and to carry out the obligations of Jacoby with Associated Oil Company, including payment of taxes, execution of leases, drilling of any and all oil wells required or permitted, receiving, storing and selling oil products; the trustees being authorized as successors to

Jacoby in and to said contracts, should occasion arise (R. 65) to develop and drill for oil and gas, to buy and sell oil products and to make contracts generally as required to protect said royalty contracts; neither the trustees nor the beneficiaries to be personally liable for obligations of the trust, which shall bind the trust estate only (R. 71).

On August 14, 1931 (R. 47, 106) the trustees adopted a resolution, and entered into a contract with Associated, dated June 15, 1931, wherein the trustees agreed to accept until April 1, 1931, 7½% of the value of oil and gas distributed to Associated under a conservation and unified development program for the North Dome Kettleman Hills oil field in lieu of the royalties for said period provided to be paid by said agreement of May 5, 1928. The trust was paid by Associated at said time the sum of $5000.00 to which it was entitled under said contract on the production of oil or gas from the lands embraced in said Watson permit (R. 91, 109).

Associated made discovery of oil or gas under said Watson permit satisfactory to the Secretary of the Interior and under date of September 30, 1930, United States Government "A" and "B" leases were issued to Associated as lessee (R. 48). In the interests of economy and conservation the operators in the North Dome area, including Associated, formed a corporation having the corporate title of "Kettleman North Dome Association" to which were assigned various government oil and gas leases for unified development, conservation and production, each assignor being entitled to a pro rata of the general production

from the lands held by said corporation, rather than the entire production from the specific land covered by the respective leases thus assigned. Associated assigned its "A" and "B" leases to said corporation and requested petitioner herein, as a royalty holder under said leases, to consent to such assignment (R. 49). Following conferences between the trustees of petitioner, Associated and representatives of the Department of the Interior interested in said conservation program such consent was given (R. 49) by the adoption of a resolution by the trustees and petitioner's execution of an agreement with Associated under date of August 10, 1932, modifying said royalty contract of May 5, 1928, to the extent of petitioner's consenting as a royalty holder to said prior assignment of said government leases by Associated to Kettleman North Dome Association and agreeing to accept its royalty based on Associated's pro rata of the general production, as aforesaid, rather than on the specific acreage covered by the original agreement of May 5, 1928, except that the royalty on the "B" acreage was increased from 2½% to 3½% while subject to such conservation plan (R. 111).

On September 20, 1933, at the request of Associated and representatives of the Department of the Interior (R. 51) interested in the conservation program, petitioner adopted a resolution whereby it consented as a royalty owner to Associated's becoming a member of Middle Dome Corporation and to receiving its royalty under its contract of July 9, 1924, from Associated's pro rata of the total production under the cooperative drilling and conservation plan

rather than from the specific acreage covered by said contract (R. 52-55).

The sole and only income ever received by petitioner has been the payments of the $5000.00 and the royalties in cash, starting in 1931, both pursuant to said royalty contract of May 5, 1928, as modified by said agreements of June 15, 1931 and August 10, 1932, with respect to the Kettleman North Dome conservation arrangements (R. 55, 56).

Petitioner has never elected to, or received, any royalty in kind (R. 55-56). Petitioner has never taken any act or adopted any resolution dealing with the receiving, or not receiving, of royalty in kind.

All of said income, less expenses of management and taxes, has been distributed pro rata from time to time as accumulated to the holders of said certificates of beneficial interest (R. 56).

Petitioner has never had any regularly employed personnel, or employees, other than the trustees themselves, two of whom act as counsel and bookkeeper respectively (R. 56, 57).

The sole and only assets of petitioner at all times have been said contracts with Associated, which have remained in full force and effect, except as modified as hereinbefore set forth, the government leases referred to, or contemplated therein, having been secured and held by Associated in Associated's name as lessee (R. 57).

Except as herein set forth, the sole and only activities of petitioner and its trustees at all times since

its creation have been the receipt and disbursement of royalty payments in cash, as aforesaid, and incidental duties, such as meetings of the trustees, keeping of books, transferring of certificates of beneficial interest and the making of Federal and state returns and reports (R. 57, 58).

On the foregoing facts the Commission of Internal Revenue determined income and excess profits tax liabilities against petitioner for the tax years 1934, 1935 (R. 11) and 1936 (R. 23) in the aggregate amount of $7634.40 solely on his conclusion that petitioner was "an association" taxable as a corporation, rather than a trust. Two separate petitions for redetermination were filed by petitioner with the United States Board of Tax Appeals.

RULINGS OF THE BOARD OF TAX APPEALS AND THE COURT BELOW.

In an unpublished consolidated memorandum opinion (R. 32) the Board of Tax Appeals determined that petitioner was an association during the tax years in question and held petitioner liable for tax deficiencies as determined by the Commissioner. Decision was entered accordingly (R. 41).

The Circuit Court of Appeals affirmed the decision of the Board of Tax Appeals and held petitioner liable to income and excess-profits taxes at corporate rates as an association (R. 138).

REASONS FOR GRANTING THE PETITION.

1. The decision of the Circuit Court of Appeals in holding that the successive decisions of petitioner to take its royalty in cash and not to take it in kind is the doing of business by petitioner giving rise to tax liability as an association (predicated on the court's argumentatively assumed hypothesis that had petitioner elected to take in kind it would have been obliged to engage in the business of selling such material, with the power given in the trust indenture so to do (R. 141)) is in conflict with the decisions of the Circuit Courts of Appeal of other jurisdictions, namely:

Gardiner v. United States, 49 F. (2d) 992 (C.C.A. 1);

Dunbar et al. v. Commissioner of Internal Revenue, 65 F. (2d) 447 (C.C.A. 1);

Myers v. Commissioner of Internal Revenue, 89 F. (2d) 86 (C.C.A. 7);

Cleveland Trust Co. v. Commissioner of Internal Revenue, 115 F. (2d) 481 (C. C. A. 6) (Pet. for Cert. denied, 85 L. Ed. Advance Opinions 664);

United States v. Davidson, 115 F. (2d) 799 (C.C.A. 6).

2. In so holding the Circuit Court of Appeals has decided a Federal question in a way probably in conflict with applicable decisions of this court, namely:

Zonne v. Minneapolis Syndicate, 220 U. S. 187, 31 S. Ct. 361, 55 L. Ed. 428;

McCoach v. Minehill R. R. Co., 228 U. S. 295, 33 S. Ct. 419, 57 L. Ed. 842;

Morrissey, et al., Trustees v. Commissioner, 296 U. S. 344, 80 L. Ed. 263, 56 S. Ct. 289.

3. The decision of the Circuit Court of Appeals in holding that the acts of petitioner in modifying its royalty contracts in connection with the oil operators' and government's oil and gas conservation program constituted the doing of business by petitioner giving rise to tax liability as an association, because petitioner exercised its business judgment in so doing (R. 142), is in conflict with the decisions of the Circuit Courts of Appeal of other jurisdictions, namely:

Cleveland Trust Company v. Commissioner of Internal Revenue, 115 F. (2d) 481 (C.C.A. 6);

United States v. Davidson, 115 F. (2d) 799 (C.C.A. 6).

4. In so holding the Circuit Court of Appeals has decided a Federal question in a way probably in conflict with an applicable decision of this court, namely:

Morrissey, et al., Trustees v. Commissioner, 296 U. S. 344, 80 L. Ed. 263, 56 S. Ct. 289.

CONCLUSION.

For these reasons it is respectfully submitted this petition should be granted.

Dated, San Francisco, California,
April 14, 1941.

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No.

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Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

OPINIONS OF THE BOARD OF TAX APPEALS AND THE COURT BELOW.

The unreported memorandum opinion of the United States Board of Tax Appeals, entered January 23, 1940, appears at page 32 of the record. The opinion of the Circuit Court of Appeals, filed December 19, 1940, with rehearing denied January 21, 1941, appears at page 138 of the record. It is reported in 116 F. (2d) 382.

JURISDICTION.

The jurisdictional statement set forth in the petition (p. 2), for the sake of brevity, is adopted and incorporated herein.

STATEMENT.

The essential facts are stated in the petition, page 4. Of such facts it is desired to emphasize the following:

1. Petitioner was given broad incidental powers to be used for the protection of the trust corpus, should the occasion arise (R. 65).

2. The beneficiaries have not participated in its management (R. 58);

3. Contracts entitling one Smith to oil royalties from Associated Oil Company were assigned to petitioner (R. 43). These contracts, which were negotiated and executed long prior to the formation of petitioner (R. 42) (as modified by changes thereto arising from petitioner's consent to the government's oil conservation program) (R. 47, 48, 49, 51, 105, 106, 111) constitute petitioner's entire trust corpus (R. 57);

4. These contracts are liquidating contractual assets, as they cover depleting natural resources (R. 82, 86, 91, 106, 111).

5. The relationship between petitioner and Associated at all times has been that of obligee—obligor, not that of principal agent (R. 82, 86, 91, 105, 106, 111);

6. Petitioner has never received any income other than cash (R. 55) and has never exercised any election to receive its royalties in kind (R. 57);

7. Petitioner has distributed to its beneficiaries all of its income (less administrative expenses and taxes) periodically as received (R. 56, 122).

ARGUMENT.

I.

THE DECISION OF THE CIRCUIT COURT OF APPEALS HOLDING THAT THE SUCCESSIVE DECISIONS OF PETITIONER TO TAKE ITS ROYALTY IN CASH AND NOT TO TAKE IT IN KIND IS THE DOING OF BUSINESS IS IN DIRECT CONFLICT WITH THE DECISIONS OF THE CIRCUIT COURTS OF APPEALS OF OTHER JURISDICTIONS AND IN SO HOLDING SAID COURT HAS DECIDED A FEDERAL QUESTION IN A WAY PROBABLY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT.

A. SUCH HOLDING IS IN DIRECT CONFLICT WITH THE DECISIONS OF THE CIRCUIT COURTS OF APPEALS OF OTHER JURISDICTIONS.

The opinion of the court below is bottomed on the proposition that the making of successive yearly decisions by petitioner to accept royalty in cash rather than in kind "is doing the business" (R. 142). The court below reached this conclusion by stating in substance that, if petitioner had elected to take in kind it would have had to dispose of the material thus taken, which necessarily would have involved the business of selling, an activity contemplated and authorized by the trust indenture (R. 141). As petitioner rests its case on the facts as they are, rather

than what they might have been had petitioner conducted itself differently; and, as petitioner never has received any royalty in kind, or performed the attendant profit-seeking acts of storing, selling or otherwise dealing with such material, that hypothetical portion of the opinion may be disregarded (*McCoach v. Minehill R. R. Co.,* 228 U. S. 295 at 305, 33 S. Ct. 419, 57 L. Ed. 842) except to the extent that the court thereby pointed out the existence of power or authority which was not used. There remains then the meat of the holding to the effect that the mere receipt and disbursement of cash received by reason of ownership of property (time honored trust functions) *plus* the *unexercised* power to depart from such purely trust functions and go into business, is the doing of business.

It is respectfully submitted such holding is in direct conflict with the following decisions of the Circuit Courts of Appeal of other jurisdictions:

The question presented in *Gardiner v. United States,* 49 F. (2d) 992 (C. C. A. 1) was whether the existence of unused broad powers in a trust organized to acquire certain properties from probate trustees and other properties, and generally to deal with the same, made the concern an association within the meaning of section 700(a) of the Revenue Act of 1924, 43 Stat. 253, 325, which is similar in that respect to the sections of the 1934 and 1936 acts under consideration. The court answered the question in the negative, stating the crucial test was in what the trustees actually did and not in the mere existence of long unused broad powers (p. 996).

Gardiner v. United States, supra, was followed in *Dunbar v. Commissioner of Internal Revenue,* 65 F. (2d) 447 (C. C. A. 1), the same question being before the court for determination with respect to a trust owning and holding real estate, the Revenue Acts of 1924 and 1926, containing similar provisions, being involved.

Myers v. Commissioner of Internal Revenue, 89 F. (2d) 86 (C. C. A. 7) similarly involved the question of the taxation of a trust, owning a single improved piece of real estate, under the applicable sections of the Revenue Acts of 1926 and 1928. The trustees had broad powers, including the right to hold, manage and dispose of the property and to exercise the same rights as if they were the absolute owners (p. 88), but did little except collect the rents and keep the building in a tenantable condition. The Commissioner's contention that the tax as an association should be sustained, because of the broad powers given the trustees, was unavailing and the decision of the Board upholding the tax was reversed.

In *Cleveland Trust Co. v. Commissioner of Internal Revenue* (115 F. (2d) 481, C. C. A. 6) (Petition for Certiorari denied 85 L. ed. Advance Opinions 664), the similar question was involved of whether a trustee corporation, owning a leased office building, was liable to taxation as an association under Section 801(a) (2) of the Revenue Act of 1934, herein involved. The trust, organized for investment purpose, acquired an improved property leased for ninety-nine years, subject to the lease, in trust for the use and benefit of holders of beneficial interests, there being 535 such

units. The trustee had the exclusive right to manage and control the estate as though it were the sole legal and equitable owner, with the right to make agreements, modifying, amending or supplementing the lease at its discretion. It exercised such authority by releasing the lessee and negotiating a new lease. The court held that the right to possession and disposition of the property, to lease or relet it, in case of default by the lessee, did not have the effect of making it an association.

To the same effect is the holding in *United States v. James E. Davidson,* 115 F. (2d) 799 (C. C. A. 6) involving the taxability of a trust as an association under the applicable provisions of the Revenue Act of 1934, supra. The trust was created by the assignment to a trustee of corporate stocks, bonds, notes, and bank deposits, to be held by the trustee for the beneficiaries or shareholders. There were 40,000 of these shares represented by transferable certificates. It had wide powers permitting it to sell, endorse commercial paper, lend and borrow money, etc. Although the trust indenture recited it was for the primary purpose of converting its assets into money and distributing the same to its beneficiaries, by its terms it was to terminate on the death of the last survivor of the trustor's children, or previously by the trustee. It was organized in 1923, but distribution did not start until 1935. It lent large sums of money to corporations in which it had stock interests, exceeding in one instance in excess of $1,600,000 and in the aggregate to another corporation in excess of $432,000. The government urged that the broad pow-

ers and quasi-corporate form of the trust required it to be taxed as an association. The court held otherwise, sustaining the District Court's finding for the taxpayer. Capital stock taxes were also recovered by the taxpayer in the same action.

B. THE CIRCUIT COURT OF APPEALS HAS DECIDED A FEDERAL QUESTION IN A WAY PROBABLY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT.

It is respectfully submitted in so holding the Circuit Court of Appeals has decided a Federal question in a way probably in conflict with the following decisions of this Court:

Zonne v. Minneapolis Syndicate, 220 U. S. 187, 31 S. Ct. 361, 55 L. Ed. 428, holding that

> "a corporation, the sole purpose whereof is to hold title to a single parcel of real estate subject to a long lease and, for convenience of the stockholders, to receive and distribute the rentals arising from such lease and proceeds of disposition of the land, and which had disqualified itself from doing any other business, is not a corporation doing business within the meaning of the corporation tax provisions of the act of August 5, 1909, C. 6, 36 Stat. 11, 112, and is not subject to the tax" (p. 187).

In the early case of *McCoach v. Minehill R. R. Co.,* supra, decided in 1913, in construing the Corporation Tax Law of 1909, supra, the analagous argument was made by the Government, as here made by the court, to the effect that a railroad corporation which had leased its railroad to another company operating it exclusively, but which maintained its corporate existence and collected and distributed to its stockhold-

ers the rental from investments was "doing business" within the meaning of the Corporation Tax Act of 1909. The court, speaking through Mr. Justice Pitney, stated on this point at page 305:

> "It should be mentioned that there is nothing in the record to show that during the taxing years in question the company exercised its powers of eminent domain or put in force any other special corporate power in aid of the business of the lessee. We therefore do not pass upon the question whether, if it should do so, it would be taxable under the act in question. We cannot, however, agree with the contention made in behalf of the Government that because the Minehill Company retains its franchise of corporate existence, maintains its organization, and holds itself ready to exercise its franchise of eminent domain, or other reserve power, if and when required by the lease, and ready to resume possession of the property at the expiration of the lease, it is therefore to be treated as doing business, in respect of the railroad, within the meaning of the Corporation Tax Law."

Having in mind the express and implied powers of railway corporate charters and in fact the powers mentioned in the quoted portion of the opinion, it must be apparent that the Minehill Railway Company had power to do many acts of a business nature, either annually, monthly, or daily, had it elected so to do; and that it not only expressly as to some, but tacitly as to others, determined not to exercise such powers. And yet, if one agrees with the reasoning of the Circuit Court of Appeals in the case at bar, such conclusions were "business judgments" consti-

tuting doing business. This court thought otherwise. The case is the controlling authority on the point today. See *Sears v. Hassett,* 111 F. (2d) 961 at p. 964 (Capital Stock Tax) and *Cleveland Trust Co. v. Commissioner of Internal Revenue,* supra, at p. 483 (Income Tax).

Although used by the First Circuit to decide a capital stock question, the *McCoach* case, supra, was followed in *Sears v. Hassett,* supra, as being binding on it in determining the question "with respect to carrying on or doing business for any part of such year" (p. 964) the court stating at page 965:

> "The *McCoach* case has been distinguished on its facts in later years (citing cases). It has not, however, been disapproved and we must accept it as a binding authority. See *Kingkade Hotel Co. v. Jones,* D. C. 30 F. Sup. 508."

In the *Sears* case the court was dealing with a trust having broad powers which had been used in part affirmatively by the trustees in prior years in the profit-seeking activities of securing a long-term tenant for a building owned by the trust and selling off parcels of land owned by the trust, so as to give rise to income tax liability as an association, although such use was not the basis upon which the court placed such liability, as it is respectfully submitted it should have done. But there the court rightly considered itself bound by the *McCoach* case as a controlling authority on the second and narrower question in the case whether, in the same and additional tax years, the trust was "doing business" so as to give rise to capital stock tax liability. Although the scope

of inquiry is broader in the former than in the latter case, in view of the fact that profit-seeking activities both within and prior or subsequent to the tax years in question, form, and purpose are relevant as to income tax liability as an association, whereas, only the question of doing business within the tax years in question is relevant as to the capital stock tax; nevertheless where, as in the case at bar, the issue has been narrowed and the only inquiry is whether the entity has done, or is doing business, the test on that narrow point is the same, and authorities controlling the one situation control the other. It is apparent that if the proposition relied on by the Circuit Court of Appeals in the case at bar were valid, the "business judgments" exercised by the trustees in the *Sears* case in refraining, in the capital stock tax years in question, from exercising their broad powers, would have constituted "the doing of business" requiring the imposition of the capital stock tax. Also, if such proposition were valid the court in that case could have relied on such doing of business in holding the taxpayer to be an association rather than relying erroneously, it is respectfully submitted, on the presence of unused power, as the court did (Cf. pp. 963-964).

There remains to be considered on this point the leading case of *Morrissey, et al., Trustees, v. Commissioner,* 296 U. S. 344, 80 L. Ed. 263, 56 S. Ct. 289, not because of its facts, which are quite dissimilar from those in the case at bar, but because of the criteria for distinguishing between trusts and associations laid down by the Chief Justice, and because the Cir-

cuit Court of Appeals relied on that case alone in its opinion (R. 142, 143). The Circuit Court stated at page 142:

> "It is our opinion that in making these successive decisions whether it will require the delivery of the royalty product in kind or in cash, the taxpayer 'is doing the business' within the decision of *Morrissey v. Commissioner,* 296 U. S. 344, 360, though through the tax years in question it thought it better business to accept cash rather than the oil products."

No portion of the Chief Justices' opinion is cited as being the authority for the novel proposition that the decision of trustees, whether periodic or otherwise, to confine themselves to non-business functions (the mere receipt and disbursement of money) is the doing of business. It would seem that the decision to do a thing, the doing of which is not "doing business" cannot be doing business. Furthermore, the Circuit Court of Appeals' opinion lacks a desirable degree of candor in failing to set forth that petitioner has never taken its royalty in kind. In fact the intimation in the opinion is the other way by the under-statement that, *"through the tax years in question* it thought it better business to accept cash rather than oil products". (R. 142) (emphasis supplied)

And it is respectfully submitted nothing in the *Morrissey* opinion justifies such holding.

Indeed, the language in the *Morrissey* case would appear to point the other way, toward a connotation of profit seeking activity as being one of the con-

trolling criteria, rather than passivity, in view of the Chief Justice's statement at pages 356 and 357 in said opinion that

> "'Association' implies associates. It implies the entering into a joint enterprise, and as the applicable regulation imports, an enterprise for the transaction of business. * * * In what are called 'business trusts' the object is not to hold and conserve particular property, with incidental powers as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains."

II.

THE DECISION OF THE CIRCUIT COURT OF APPEALS IN HOLDING THAT THE ACTS OF PETITIONER IN MODIFYING ITS ROYALTY CONTRACTS IN CONNECTION WITH THE OIL OPERATORS' AND GOVERNMENT'S OIL AND GAS CONSERVATION PROGRAM CONSTITUTED THE DOING OF BUSINESS BY PETITIONER GIVING RISE TO TAX LIABILITY AS AN ASSOCIATION, BECAUSE PETITIONER EXERCISED ITS BUSINESS JUDGMENT IN SO DOING, IS IN CONFLICT WITH THE DECISIONS OF THE CIRCUIT COURTS OF APPEALS OF OTHER JURISDICTIONS AND IN SO HOLDING SAID COURT HAS DECIDED A FEDERAL QUESTION IN A WAY PROBABLY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT.

A. SUCH HOLDING IS IN DIRECT CONFLICT WITH THE DECISIONS OF THE CIRCUIT COURTS OF APPEALS OF OTHER JURISDICTIONS.

The opinion states petitioner exercised "its business judgment" in entering into these "new" contracts. But what of it? Even trustees of pure or traditional trusts are permitted to use their business judgment in the protection of the trust corpus. In

fact, the more and better business judgment a trustee uses in switching from a bad or failing security holding to a good and solvent one, or in performing other protective acts, the better trustee presumable he would be. That is one of a trustee's functions. The *motive* is the important thing. The trustees consented to, or entered into, the North Dome and Middle Dome arrangements, as the stipulated facts clearly indicate, under exceptional circumstances and with the absence of any profit-seeking motive. They had no real alternative. They were not seeking after profits, but seeking to preserve what had been entrusted to their care. To stress the fact that "new contracts" or different contracts, in a technical, or even an actual sense, were made, is to grasp at the form and lose the substance of the matter.

It is respectfully submitted such holding is in direct conflict with the following decisions of the Circuit Courts of Appeals of other jurisdictions:

In *Cleveland Trust Company v. Commissioner of Internal Revenue* (C. C. A. 6) supra, the facts of which have already been stated, the court, in commenting on the right of trustees to deal with the trust's property as being an incidental power to be used under exceptional circumstances, stated at p. 484:

> "Under ordinary trusts, trustees are often empowered to substitute investments or sell property and to lease and rent the corpus of the trust, but to hold such transactions as creating an association for profit would be in effect to subject such trusts to the taxable status of corporations."

See also to same effect Note 10 at page 18 of *Fidelity-Bankers Trust Co. et al. v. Helvering,* 113 F. (2d) 14 (D. C.) regarding transactions of a business nature in connection with the preservation of trusts.

And, in *United States v. Davidson* (C. C. A. 6), supra, the facts of which also have been stated, the court approved the findings of the District Court that there was no conclusive evidence that the trust was engaged in business for the purpose of a livelihood or profit (p. 801). In fact the court found that the trustee had not so engaged and that the trustee "has done no more than hold and attempt to preserve the trust property and receive the ordinary fruits arising from its ownership" (p. 801). And yet, surely the acts of the trustee in lending over $2,000,000 to the sugar and steamship companies to protect the trustee's prior loan and his stockholdings must have called for the use of the trustee's "business judgment".

In the case at bar the "business activities" referred to in the opinion (R. 142) were of a non-profit seeking nature in the same sense (but for more obvious reasons) the successive acts of the trustee, in lending large sums of money in *United States v. Davidson,* supra, were held to be nonbusiness activities and incidental to the main purpose of the trust. As the stipulated facts in the case at bar show, the modifications of the royalty contracts were made in cooperation with the Department of the Interior and after Associated *had already assigned* the underlying leases to the Kettleman North Dome Association, all in

conformity with supervening public welfare, as part and parcel of a federal conservation program. It is not apparent what alternative to consenting the trustees had. It cannot fairly be stated that such acts of the trustees were profit-seeking. Indeed, the court did not so state. We have then, the holding of the court that acts of business judgment (even though devoid of profit-seeking motive) constitute the doing of business. It is respectfully submitted such holding is in direct conflict with the cases from other circuits cited herein and lays down a thoroughly unsound and unworkable rule of law.

B. THE CIRCUIT COURT OF APPEALS HAS DECIDED A FEDERAL QUESTION IN A WAY PROBABLY IN CONFLICT WITH AN APPLICABLE DECISION OF THIS COURT, NAMELY MORRISSEY, ET AL., TRUSTEES v. COMMISSIONER (SUPRA).

The governing principles with respect to the taxation of trusts as associations were laid down in the *Morrissey* case, supra. Nowhere therein is it suggested that the non-profit seeking acts of trustees for the protection of the trust corpus would constitute the doing of business; on the contrary that trustees might use their incidental power, without tax penalty, in the conservation of the trust property (in conjunction with their business judgment it is hoped) was recognized (but without taking the occasion to emphasize the point) in the following language therein:

> "In what are called 'business trusts' the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gain" (p. 357).

CONCLUSION.

The Circuit Court of Appeals has rendered a decision which not only is in conflict with numerous decisions of other Circuit Courts of Appeals and of this Court, but also in so doing it has enunciated unsound and unworkable criteria for distinguishing between trusts and associations and what constitutes doing business, certain to introduce additional confusion into an already confused distinction of real importance in the administration of the revenue laws.

It is respectfully submitted the Petition for Certiorari should be granted.

Dated, San Francisco, California,
April 14, 1941.

ROBERT HOLLAND ECKHOFF,
Counsel for Petitioner.

MAURICE E. GIBSON,
Of Counsel.

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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 958

KETTLEMAN HILLS ROYALTY SYNDICATE NO. 1, A TRUST, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the United States Board of Tax Appeals (R. 32–40) is not reported. The opinion of the Circuit Court of Appeals (R. 138–143) is reported in 116 F. (2d) 382.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Ninth Circuit was entered December 19, 1940. (R. 143.) A petition for rehearing was filed January 17, 1941, and denied on January 21,

1941. (R. 144.) A petition for a writ of certiorari was filed April 17, 1941. The jurisdiction of this Court is invoked under Section 240 (a), Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer trust is an association taxable as a corporation within the meaning of Sections 801 (a) (2) and 1001 (a) (2) of the Revenue Acts of 1934 and 1936, respectively.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra,* pp. 12–16

STATEMENT

The facts as stipulated (R. 42–122), and found by the Board of Tax Appeals (R. 33–38), are as follows:

Robert Hayes Smith held a permit from the United States for prospecting for oil and gas on certain lands. By contract, on May 5, 1928, he authorized Associated Oil Company to attempt discovery of oil and gas, secure a Government lease, and operate the property, paying him a one-sixth royalty. This agreement was modified and supplemented on February 19, 1930. Likewise in 1928, Smith made a somewhat similar contract with Associated as to other lands respecting which he held a prospecting permit. (R. 33.)

On May 3, 1930, Smith assigned his interests in the contracts to one Jacoby, a duly licensed oil royalty broker, who acquired the contracts for the purpose of placing them in trust and receiving certificates of beneficial interest which he could sell to the public. On the same day taxpayer was organized, by execution of an agreement and declaration of trust on the part of Jacoby as "Subscriber" and three parties as "Trustees". Jacoby assigned his interests to the trustees as the entire corpus of the "trust" and received certificates representing 4,000 equal interests of the par value of $1,000 each, representing the entire beneficial interest. These were transferable by endorsement of the holders. They have since been acquired by various persons, the number ranging from 57 in 1931 to 628 in 1939. (R. 33–34.)

The "Agreement and Declaration of Trust" provided, *inter alia,* as follows (R. 34–36):

> That the trustees agree to hold in trust the property delivered to them, as well as all other property which they may acquire as such trustees and all moneys, properties and securities accruing therefrom that may be received by them, to handle, improve, manage and dispose of the same and to collect, receive and distribute the income and profits therefrom to the holders of certificates; that legal title, ownership and control of the estate is vested in the trustees; that the trustees shall conduct all business and execute all instruments under the name of Kettleman Hills Royalty Syndicate or other

name to be selected; that the trustees acknowledge receipt of the property which, with any other property which may be acquired by them for the purposes provided by the agreement, shall be received, held, owned, controlled, managed and applied to the uses mentioned in the instrument; that the trustees will carry out the obligations of Jacoby with Associated, including payment of taxes, execution of leases, drilling of any and all oil wells required or permitted, receiving, storing and selling oil, gas and gasoline, and will protect the interests under the agreement in any manner they may deem proper; that the trustees shall collect and receive the royalties and distribute the net income and profit therefrom to the holders of certificates; that they are authorized, in furtherance of the interests of the "trust estate" to develop and drill for oil and gas, to buy and sell oil, gas, gasoline or hydro-carbon substances, to enter into or acquire franchises, contracts or concessions in relation to the operation of the estate and to do all things necessary to the purposes of the organization * * *; that the trustees shall not be personally liable by virtue of any contract, but same shall fully bind the property of the trust estate; that all expenses, arising from contract or tort shall be paid out of the assets and properties of the trust estate; that the trustees shall bring any suits or actions necessary, and defend or compromise same, and pay judgments; that the trustees shall hold title to all property

and manage and control same and be free from control or management by certificate holders, who shall not have power to remove a trustee, except through the courts; that certificate holders shall not be liable for indebtedness or liability of the trust estate or its operation.

On April 27, 1931, the trustees, at the request of Associated, consented to an application by Smith as original permittee to the Secretary of the Interior for an extension of time for further exploration. They also entered into a contract as of June 15, 1931, after several months' negotiations with Smith, Associated, and representatives of the Department of the Interior, whereby Smith and Associated agreed to accept for the period up to April 1, 1931, a percentage of oil or gas under a unified cooperative development and conservation plan for the North Dome Kettleman Hills Oil Field in lieu of the royalty payment provided by the agreement of May 5, 1928. Associated agreed to pay Smith and taxpayer $5,000 and 7½ percent of amounts received by Associated under the plan of unified cooperative development as taxpayer's royalty on certain lands. Smith in turn authorized the payment of the moneys to taxpayer. A resolution by the trustees recited that this was to the best interests of the taxpayer. (R. 36.)

As to certain other lands, the trustees on September 20, 1933, with reference to a similar cooperative development plan, executed a "Lessors' and

Royalty Owners' Consent" that Smith and Associated might become members of Middle Dome Corporation, which should have the management of the cooperative development and conservation. The taxpayer thereby agreed to receive its pro rata part of the total production under the plan. The only income received by taxpayer has been under the contracts above described, which income, less expenses, has been distributed to the holders of beneficial certificates. (R. 37.) It is further stipulated concerning all the royalties received by the taxpayer in the tax years in question that they were received from the North Dome lands under agreement of May 5, 1928, providing that (R. 92):

> Second party [Associated] agrees to pay to first party [taxpayer] a royalty of 7½% of the value at the well of all oil and/or gas produced and sold by second party (except oil or gas used for production purposes or unavoidably lost) * * *, or, at first party's [taxpayer's] option, exercised not oftener than once in any one calendar year, upon sixty days' previous written notice, second party will deliver into first party's tanks on the said premises, or at the mouth of well to pipe line designated by first party, first party's 7½% of said oil.

and the later modifying agreements retaining this option provision. (R. 55–56, 119; see also R. 140.)

Taxpayer has no regular employees other than the trustees, two of whom act as counsel and bookkeeper, respectively. The trustees have also

transferred certificates of beneficial interest, made state and federal returns and reports, made an annual report to the certificate holders, corresponded with them with reference to income, corresponded with Associated, receiving monthly reports of production and discussing the selling price of oil and gas, and have had interviews with certificate holders and officials and employees of Associated. The trustees have kept a record of all meetings and resolutions. Moneys have been distributed to certificate holders four or five times a year, ranging from a total of approximately $6,000 in 1931 to a total of approximately $18,000 in 1938. (R. 37–38.)

Upon the basis of the foregoing facts, the Board held that the taxpayer was an association taxable as a corporation during the taxable years 1934, 1935, and 1936, and entered its decision affirming the Commissioner's determination. (R. 41.) From this decision the taxpayer petitioned for review to the Circuit Court of Appeals for the Ninth Circuit, which affirmed the judgment below.

ARGUMENT

The basic principles for ascertaining whether this trust is an association taxable as a corporation have already been outlined in four companion cases in this Court. *Morrissey* v. *Commissioner,* 296 U. S. 344; *Helvering* v. *Coleman-Gilbert,* 296 U. S. 369; *Swanson* v. *Commissioner,* 296 U. S. 362; *Helvering* v. *Combs,* 296 U. S. 365. Here the tax-

payer's request for certiorari is founded in substance upon the contention that the Circuit Court of Appeals for the Ninth Circuit has misapplied these principles to the particular facts. We submit that the decision of the Board of Tax Appeals, and of the Circuit Court of Appeals, is in accordance with the established law and that there is no conflict with the decisions of other circuits.

In the case at bar, taxpayer presents the question as exclusively whether it is "doing business," and relies upon certain cases involving the corporation tax law of 1909 (Act of August 5, 1909, c. 6, Sec. 38, 36 Stat. 11, 112–117), i. e., *Zonne* v. *Minneapolis Syndicate,* 220 U. S. 187, and *McCoach* v. *Minehill Railway Co.,* 228 U. S. 295. The problem is not whether a corporation should be taxed to the extent of its exercise of the privilege of doing business, but whether the taxpayer is more akin to a corporation than to the traditional type of trust. (See 296 U. S. 344, at 359.) In this connection taxpayer has admitted that its form and mode of procedure are quasi corporate in character. (R. 33.) Thus it has practically all the corporate characteristics considered by this Court in the *Morrissey* case, *supra,* including centralized management, with title vested in the trustees, continuity of interest through the issuance of transferable certificates, and limited liability. It is true that whether the trust has a business purpose, and whether its activities are calculated to advance that purpose, ~~and~~ are also relevant criteria in determin-

ing whether an association exists. But in this case more than mere trust powers were granted by the original agreement, for the trustees had the power to drill wells for oil and gas, to execute leases and agreements, to buy and sell oil, gas or gasoline, to execute negotiable paper, and to do anything otherwise necessary in their discretion. Moreover, the facts are that they did enter into contracts and joined in cooperative agreements for joint development of the land. They exercised business judgment in deciding under the option whether to receive payment in cash or in the form of oil. It is further obvious that the trust had a definite profit motive; and the Board of Tax Appeals has so concluded. (R. 38–39.) This Court denied certiorari on October 14, 1940, in *Lee H. Marshall Heirs* v. *Helvering,* No. 110, present Term, with respect to an organization which exercised no more of its powers. Moreover, it is established that in ascertaining the existence of an association, the main question is the scope of the powers conferred upon the trustees by the indenture, rather than the extent to which such powers were exercised. *Helvering* v. *Coleman-Gilbert,* 296 U. S. 369, 374. See *Wholesalers Adjustment Co.* v. *Commissioner,* 88 F. (2d) 156, 157 (C. C. A. 8th); *Sears* v. *Hassett,* 111 F. (2d) 961 (C. C. A. 1st); *Fidelity-Bankers Trust Co.* v. *Helvering,* 113 F. (2d) 14 (App. D. C.); *Commissioner* v. *Vandergrift R. & Inv. Co.,* 82 F. (2d) 387 (C. C. A. 9th). But cf. *Com-*

missioner v. *Gibbs-Preyer Trusts Nos. 1 and 2,* 117 F. (2d) 619 (C. C. A. 6th).

Taxpayer claims that the case at bar is in conflict with five decisions of Circuit Courts of Appeals. Two of these cases, *Gardiner* v. *United States,* 49 F. (2d) 992, and *Dunbar* v. *Commissioner,* 65 F. (2d) 447, were both decided by the Circuit Court of Appeals for the First Circuit some years before this Court laid down the basic principles during the October Term, 1935 (*Morrissey* v. *Commissioner* and companion cases). The general proposition for which the two cases stand, namely, that the "crucial test must be found in what the trustees actually do, not in the mere existence of long unused broad powers" (49 F. (2d) 992, at 996), has since been decided squarely to the contrary in that circuit. *Sears* v. *Hassett,* 111 F. (2d) 961, at 963. The rest of the cases on which taxpayer relies (*i. e., Cleveland Trust Co.* v. *Commissioner,* 115 F. (2d) 481 (C. C. A. 6th), No. 764, present Term, certiorari denied, March 17, 1941; *United States* v. *Davidson,* 115 F. (2d) 799 (C. C. A. 6th); and *Myers* v. *Commissioner,* 89 F. (2d) 86 (C. C. A. 7th)) represent a class of decisions which this Court has declined to review. (See Government's Petition for Certiorari in *Helvering* v. *Cleveland Trust Co., supra,* p. 14.)

CONCLUSION

The decision of the court below correctly applies the statute and the governing principles established by decisions of the court to the facts of this case.

There is no conflict of decisions, and the petition should therefore be denied.

Respectfully submitted.

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Special Assistants to the Attorney General.

MAY, 1941.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 801. DEFINITIONS.
>
> (a) When used in this Act—
>
> (1) The term "person" means an individual, a trust or estate, a partnership, or a corporation.
>
> (2) The term "corporation" includes associations, joint-stock companies, and insurance companies.
>
> * * * * *
>
> (U. S. C., Title 26, Sec. 1696.)

Subsections (a) (1) and (2) of Section 1001 of the Revenue Act of 1936, c. 690, 49 Stat. 1648, are identical with those quoted above.

AS TO SECTION 801 (A) (1) AND (2) OF THE 1934 ACT

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

> ART. 801–1. *Classification of taxables.*— For the purpose of taxation the Act makes its own classifications and prescribes its own standards of classification. Local law is of no importance in this connection. Thus a trust may be classed as a trust or as an association (and, therefore, as a corporation), depending upon its nature or its activities. * * * The definitions, terms, and classifications, as set forth in section 801, shall have the same respective meaning and scope in these regulations.

ART. 801–2. *Association.*—The term "association" is not used in the Act in any narrow or technical sense. It includes any organization, created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. It includes a voluntary association, a joint-stock association or company, a "business" trust, a "Massachusetts" trust, a "common law" trust, an "investment" trust (whether of the fixed or the management type), an interinsurance exchange operating through an attorney in fact, a partnership association, and any other type of organization (by whatever name known) which is not, within the meaning of the Act, a trust or an estate, or a partnership. * * *

ART. 801–3. *Association distinguished from trust.* — The term "trust," as used in the Act, refers to an ordinary trust, namely, one created by will or by declaration of the trustees or the grantor, the trustees of which take title to the property for the purpose of protecting or conserving it as customarily required under the ordinary rules applied in chancery and probate courts. The beneficiaries of such a trust generally do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. Even though the beneficiaries do create such a trust, it is ordinarily done to conserve the trust property without undertaking any activity not strictly

necessary to the attainment of that object.

As distinguished from the ordinary trust described in the preceding paragraph is an arrangement whereby the legal title to the property is conveyed to trustees (or a trustee) who, under a declaration or agreement of trust, hold and manage the property with a view to income or profit for the benefit of beneficiaries. Such an arrangement is designed (whether expressly or otherwise) to afford a medium whereby an income or profit-seeking activity may be carried on through a substitute for an organization such as a voluntary association or a joint-stock company or a corporation, thus obtaining the advantages of those forms of organizations without their disadvantages.

If a trust is an undertaking or arrangement conducted for income or profit, the capital or property of the trust being supplied by the beneficiaries, and if the trustees or other designated persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the beneficiaries are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classified by the Act as a corporation.

By means of such a trust the disadvantages of an ordinary partnership are avoided, and the trust form affords the advantages of unity of management and continuity of existence which are characteristic of both associations and corporations. This trust form also affords the advantages of capacity, as a unit, to acquire, hold, and dispose of property and the ability to sue and be sued

by strangers or members, which are characteristic of a corporation; and also frequently affords the limitation of liability and other advantages characteristic of a corporation. These advantages which the trust form provides are frequently referred to as resemblance to the general form, mode of procedure, of effectiveness in action, of an association or a corporation, or as "quasi-corporate form." The effectiveness in action in the case of a trust or of a corporation does not depend upon technical arrangements or devices such as the appointment or election of a president, secretary, treasurer, or other "officer," the use of a "seal," the issuance of certificates to the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a "charter" or "by-laws," the existence of "control" by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing them should be treated as a corporation, but they are not essential to such classification, for the fundamental benefits enjoyed by a corporation, as outlined above, are attained, in the case of a trust, by the use of the trust form *itself*. The Act disregards the technical distinction between a trust agreement (or declaration) and ordinary articles of association or a corporate charter, and all other differences of detail. It creates such a trust according to its essential nature, namely, as an association. This is true whether the beneficiaries form the trust or, by purchase or otherwise, acquire an interest in an existing trust.

The mere size or amount of capital invested in the trust is of no importance. Sometimes the activity of the trust is a small

venture or enterprise, such as the division and sale of a parcel of land, the erection of a building, or the care and rental of an office building or apartment house; sometimes the activity is a trade or business on a much larger scale. The distinction is that between the activity or purpose for which an ordinary strict trust of the traditional type would be created, and the activity or purpose for which a corporation for profit might have been formed.

* * * * *

AS TO SECTION 1001 (A) (1) AND (2) OF THE 1936 ACT

Articles 1001–1 and 1001–2 of Treasury Regulations 94, promulgated under the Revenue Act of 1936, are substantially the same as Articles 801–1 and 801–2 of Treasury Regulations 86.

Article 1001–3 of Treasury Regulations 94 is substantially the same as Article 801–3 of Regulations 86, except that the following has been added to paragraphs 2 and 3, respectively, of the former:

Paragraph 2:

The nature and purpose of a cooperative undertaking will differentiate it from an ordinary trust. The purpose will not be considered narrower than that which is formally set forth in the instrument under which the activities of the trust are conducted.

Paragraph 3:

However, the fact that the capital or property of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association.

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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1940

No. 958

KETTLEMAN HILLS ROYALTY SYNDICATE No. 1 (a trust),

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

PETITIONER'S REPLY BRIEF.

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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1940

No. 958

KETTLEMAN HILLS ROYALTY SYNDICATE No. 1 (a trust),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

PETITIONER'S REPLY BRIEF.

Petitioner pointed out in its brief in support of its petition for certiorari that the opinion in the court below was in reality based on two propositions, neither of which petitioner believed to be sound:

First. The mere receipt by the trustees of cash received by reason of ownership of property and its disbursement to beneficiaries (time honored trust func-

tions) *plus* the *unexercised* power to depart from such purely trust functions and go into activities of a business nature is the doing of business (Cf. pp. 15-16, Pet's. Brief) and

Second. Petitioner was doing business because it exercised its "business judgment" in modifying its royalty contracts in connection with the oil conservation program, even though such acts were protective in nature and with an absence of any profit-seeking motive (Cf. pp. 24-25, Pet's. Brief).

Petitioner cited cases under each proposition indicating that such holdings were in conflict with numerous decisions of other Circuit Courts of Appeals and of this court itself.

As the brief for the respondent in opposition makes answer to the first proposition, but is silent as to the second; and, as such brief admits a conflict among the various Circuit Courts of Appeals as to the first proposition and, it is respectfully submitted, enunciates an erroneous conception of the law in support thereof (hereinafter quoted), petitioner has deemed it advisable to file this brief reply addressed only to the first proposition.

Respondent's cited cases disclose, and respondent *admits,* a conflict in the decisions of the First, Eighth and Ninth Circuit Courts of Appeals and Court of Appeals for the District of Columbia on the one hand and the Sixth Circuit on the other hand as to whether,

> "* * * in ascertaining the existence of an association, the main question is the scope of the powers conferred upon the trustees by the inden-

ture, rather than the extent to which such powers were used" (Res. Brief, pp. 9-10).

The contrariety of judicial opinion presently prevailing in the various circuits on this proposition (not to mention earlier cases cited by respondent) may be observed by contrasting the opinion in *Sears v. Hassett,* 111 F. (2d) 961 (C.C.A. 1), with *Commissioner v. Gibbs-Preyer Trusts Nos. 1 and 2,* 117 F. (2d) 619 (C.C.A. 6), both cited by respondent at pages 9 and 10 of respondent's brief and admitted by respondent to be in conflict; or by contrasting *Sears v. Hassett,* supra, with *Cleveland Trust Co. v. Commissioner,* 115 F. (2d) 481 (C.C.A. 6), No. 764, present Term, certiorari denied March 17, 1941, and with *United States v. Davidson,* 115 F. (2d) 799 (C.C.A. 6).

Respondent contends that *Helvering v. Coleman-Gilbert,* 296 U. S. 369; *Wholesalers Adjustment Co. v. Commissioner,* 88 F. (2d) 156 (C.C.A. 8); *Sears v. Hassett,* 111 F. (2d) 961 (C.C.A. 1); *Fidelity-Bankers Trust Co. v. Helvering,* 113 F. (2d) 14 (App. D.C.), and *Commissioner v. Vandergrift R. & Inv. Co.,* 82 F. (2d) 387 (C.C.A. 9), establish the affirmative of the above-quoted proposition (Res. Brief, p. 9). Whereas petitioner contends that the following cases, among many others, establish the negative of such proposition: namely, *Commissioner v. Gibbs-Preyer Trusts Nos. 1 and 2* (C.C.A. 6), supra, *Cleveland Trust Co. v. Commissioner* (C.C.A. 6), supra, and *United States v. Davidson,* supra.

As there is presented in this case real conflicts with decisions of other Circuit Courts of Appeals, and as

the decision is certain to make for confusion and uncertainty in the administration of the revenue laws, it is respectfully submitted the petition for certiorari should be granted.

Dated, San Francisco, California,
May 21, 1941.

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